TRANSMITTAL SLIP	DATE 22 Jan 82
TO: C/NIC	
ROOM NO.	BUILDING

REMARKS:

Pls return to NIO/Econ

FROM: NIO/Econ		
ROOM NO.	BUILDING	EXTENSION

FORM NO. 241 REPLACES FORM 36-8 (47)

Approved For Release 2007/07/25 : CIA-RDP84T00109R000100040025-0

MEMORANDUM FOR: C/NIC

Well worth reading.

J

Date

THE WHITE HOUSE

WASHINGTON

Executive Registry
82-2146

CABINET AFFAIRS STAFFING MEMORANDUM

DDI-469-82

DATE: 1/19/82 NUMBER: 050137CA DUE BY: -----

SUBJECT: CABINET COUNCIL ON ECONOMIC AFFAIRS -- January 21 Meeting

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☐	☑
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
	☐	☐
	☐	☐

	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Anderson	☑	☐
Clark	☑	☐
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Gray	☐	☑
Beal	☐	☑
Allen Lenz	☑	☐
Larry Kudlow	☑	☐
	☐	☐
	☐	☐
	☐	☐
	☐	☐
CCNRE/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCCT/Kass	☐	☐
CCFA/McClaughry	☐	☐
CCEA/Porter	☑	☐

REMARKS: Attached are the agenda and briefing paper on Agenda item #1 for the Thursday, January 21, meeting of the Cabinet Council on Economic Affairs, scheduled for 8:45 AM in the Roosevelt Room.

There will be no paper for the second agenda item distributed in advance of the meeting.

RETURN TO: Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

CONTACT: Kenneth Cribb, Jr.
Assistant Director
Office of Cabinet Affairs
456-2800

THE WHITE HOUSE

WASHINGTON

January 19, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER

SUBJECT: Agenda and Paper for the January 21 Meeting

The agenda and paper for the Thursday, January 21 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The first agenda item is a review of the current economic outlook. A paper, prepared by Lawrence A. Kudlow, entitled "Financial and Economic Update," is attached. This paper was coordinated with and commented on by the Department of the Treasury and the Council of Economic Advisers.

The second agenda item is a brief review of some international economic developments. Under Secretary of the Treasury for Monetary Affairs Beryl Sprinkel will report on recent discussions with senior foreign officials on international economic policy issues. No paper will be distributed in advance of the meeting for this agenda item.

STAT

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

January 21, 1982

8:45 a.m.

Roosevelt Room

AGENDA

1. Review of the Economic Outlook (CM#127)
2. International Economic Developments

 CM# 127

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

January 18, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Lawrence A. Kudlow LAK

SUBJECT: Financial and Economic Update

INTRODUCTION

Suddenly, the decline in interest rates has come to an end. After a euphoric 3-month period from late August through November, when short rates fell by 550-650 basis points and long rates declined by more than 200 basis points, interest rates during the past 7 weeks have rebounded smartly. Both short and long rates have jumped by about 150 basis points.

The rise in long rates could portend real economic damage. High quality corporate utility bonds peaked last summer at 17.75%. During the autumn bond rally they fell to 14.75%, but during the current November-January setback they have retraced upward back to nearly 17%. This is particularly worrisome because it has occurred during a period when real GNP has been declining by about 6% and unemployment has risen to nearly 9%. Thus, the traditional view of recessionary interest rate relief has not panned out.

With respect to the expected economic recovery this year, the near record level of long-term interest rates -- more important in an economic growth/investment sense than short-term rates -- is an ominous sign. If best rated bonds are financed around 16% or 17% during a recession, and if this turns out to be the bottom in the highest quality corporate rates, then prohibitive long-term investment costs during the recovery will undercut expansion in plant and equipment and undermine the supply-side tax program. And without such capital expansion, economic growth prospects become considerably less promising.

Thus, the central point is not how high interest rates have gone, but how low they have not gone. The absolute bottom for AAA utility bonds was 14 3/4% in November -- and it would take a major new rally just to get back to that point. But even if a new rally does occur (and the market chartists and technicians expect a rally soon), this would represent the highest interest rate trough in history. Indeed, until recently it would have represented the highest interest rate peak in history. And with interest rates this high, is sustainable economic recovery a realistic possibility?

A cyclical story. Why is all this happening? It seems like a repeat of the old fiscal/monetary theme: large deficits are incompatible with a sustained monetary and inflationary reduction over a period of years. In a recession, with declining private credit demands, deficits don't matter much. But in a recovery, with rising private credit needs, deficits matter a lot. The absorption of capital, the preemption of productive private borrowers, the politically-motivated subsidies, the rearrangement of market risk and the interference with monetary policy all spell trouble for future investment, economic growth and inflation.

In a real sense the market is cautioning government policymakers about prospective events: the clash of government and private financing requirements, the possibility of inflationary money growth and the likelihood of a disappointing and dampened economic recovery. The expression of these market worries is embodied in the rising structure of interest rates. This interest rate medium is the message, and the upward movement of rates is a market signal that severe fiscal problems may cause future damage to investment opportunities, inflation and economic growth. In a word, interest rates are best viewed as a proxy for expectations of the future.

What the market knows is the following:

1) Budget outlay estimates for the 1982-84 period have risen substantially since the original fiscal plan was unveiled in February 1981; and

2) The most recent Administration deficit estimates made public (the December 2 Troika package, which was published in the press on December 7) suggest that the expected recovery cycle over the 1982-1987 period will generate a deficit/GNP path much like the 1976-1980 period, a period characterized by sluggish investment and growth, high inflation and record interest rates.

3) In November the President removed from policy the pledge for a balanced budget by 1984. To many this suggests the removal of budget discipline.

Given the information currently available (the market has not received information on new Administration initiatives to generate budget deficit savings), the budget outlay drift appears as follows:

<u>Budget Drift</u>

	1982	1983	1984
The White Paper (Feb. 18)	695.5	733.1	771.6
Budget Revisions (Mar. 10)	695.3	732.0	770.2
Mid-session Review (July 15)	704.8	728.7	758.5
September Budget Initiative (Oct.6)	725.8	774.5	824.2
Dec. 2 Troika Forecast	729.4	798.8	844.7
Change Feb. 18 to Dec. 7	33.9	65.7	73.1
(Percent slippage)	(4.9%)	(9.0%)	(9.5%)

In 1982, budget estimates have drifted up by $33.9 billion, from $695.5 billion to $729.4 billion. In 1983 the drift is nearly twice as much, aggregating to $65.7 billion. By 1984 the drift totals $73.1 billion, a rise of 9.5% from the original estimate in February 1981. This is a troubling pattern, and suggests that the Administration's efforts to control spending have not matched the promises made by government or expectations held by the markets.

In addition, the December 7 news stories concerning new Administration economic assumptions and deficit projections created a wave of market fears over prospective Treasury borrowing requirements. The out-year deficit estimates contained in those news stories averaged about $150 billion. But investors undoubtedly assumed new fiscal proposals from the Administration. So for analytical purposes it seems reasonable to plug in market expectations for deficit estimates of about $100 billion in 1983, $100 billion in 1984, and $75 billion for the 1985-87 period. These are numbers now widely quoted by private forecasters. This leaves the following:

Deficit/GNP in the
Years after Recession Trough

Business Cycle	Recession Year	+ 1	+ 2	+ 3	+ 4	+ 5	Average
1958-1964	0.6% (FY 58)	2.7% (FY 59)	0.0% (FY 60)	0.7% (FY 61)	1.3% (FY 62)	0.8% (FY 63)	1.1% (FY 59-63)
1975-1981	3.1% (FY 75)	4.0% (FY 76)	2.4% (FY 77)	2.3% (FY 78)	1.2% (FY 79)	2.3% (FY 80)	2.4% (FY 76-80)
Average for all post-war recoveries	1.0%	2.2%	0.9%	0.9%	0.7%	1.3%	1.2%
1982-1987	3.2% (FY 82)	2.9% (FY 83)	2.6% (FY 84)	1.8% (FY 85)	1.7% (FY 86)	1.5% (FY 87)	2.1% (FY 83-87)

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From the market's standpoint, given all available information about fiscal policy, the deficit/GNP relationship during the next recovery period looks just about as bad as during the last recovery. Over the 1983-87 period, Federal deficits are projected to average 2.1% of nominal GNP. This almost matches the 5-year experience following the 1974-75 recession (2.4% of GNP), and it far exceeds the average deficit share of GNP for all post-war cyclical recoveries (1.2%).

So interest rate movements in recent weeks, to the extent they are influenced by fiscal events, suggest deep-rooted concerns over future government spending and borrowing. From the market's perspective the future looks much like the recent past. And there is one matter on which everyone can agree: the recent past has not been good.

Meanwhile, just to make matters worse, a new surge of undesirable money growth is now underway. On a year over year basis, the growth of M1B has gone from a low of 3.7% in early November, to 6.6% for the latest week in January. After six months of relatively slow growth -- from April through October 1981 -- money growth began a sharp expansion in November.

M1B
(% change, S.A. annual rate)

4 weeks ending	
11/4/81 - 1/6/82	14.3
5/6/81 - 11/4/81	-0.5
Difference	14.8

The rapid acceleration in M1B growth is also illustrated in recent weekly data.

M1B
(% change, S.A. annual rate)

4 weeks ending	4-Week	Smoothed*
Nov 4	2.3	2.1
Nov 18	5.7	3.8
Dec 2	16.5	10.3
Dec 16	17.7	12.0
Dec 23	16.2	12.3
Dec 30	9.4	9.8
Jan 6	10.8	10.5

* For weekly data, smoothed growth consists of the average of 4-, 9-, and 13-week growth rates.

Perhaps the jump in money is only a temporary phenomenon, a result of technical problems in the measurement of the money supply. This is always a possibility over relatively short-run periods, and this is probably the case for last week's $9.8 billion increase. But there are numerous other signals suggesting a basic change in monetary policy from steady restraint to alarming expansion.

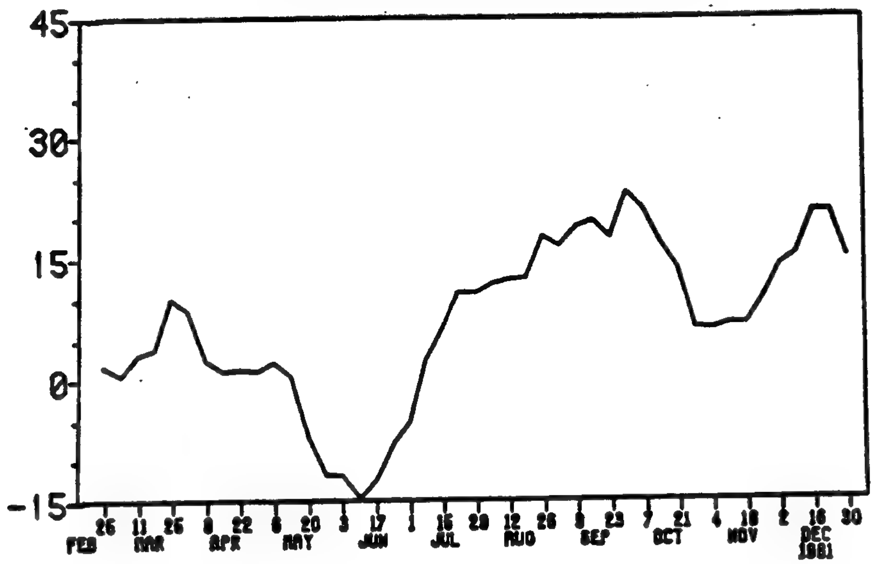
At its October and November meetings the Federal Open Market Committee (FOMC) voted for faster money growth. This new policy has been backed up by explicit open market operations. The Fed has stepped up its purchase of government securities (assets), providing the resources for a substantial acceleration in commercial bank balance sheets and bank credit.

	Federal Reserve Assets (% change, annual rate)		Commercial Bank Assets (% change, annual rate)	
4 weeks ending	Smoothed*	52-week	Smoothed*	52-week
Nov 4	13.9	3.1	-1.5	7.6
Nov 18	7.1	2.5	-1.1	7.0
Dec 2	9.5	5.0	10.8	7.9
Dec 16	26.8	6.3	17.5	8.3
Dec 30	37.2	6.0	20.9	7.4
Jan 6	29.8	5.4	NA	NA

* For weekly data, smoothed growth consists of the average of 4-, 9-, and 13-week growth rates.

On the liability side of the Fed's balance sheet, the rise in asset holdings has been matched by a surge in nonborrowed and total reserves. Growth of the monetary base (which adds currency outstanding to total reserves) has also accelerated, but thus far its pickup has not been as sharp as the two reserve measures.

NONBORROWED RESERVES
(SMOOTHED GROWTH RATES)*



* For weekly data, smoothed growth consists of the average of 4-, 9-, and 13-week growth rates, seasonally adjusted at annual rates.

(Seasonally adjusted, Annualized rates of growth)

4 weeks ending	St. Louis Monetary Base	Total Reserves	Nonborrowed Reserves
11/4/81 - 1/6/82	7.1	10.6	16.9
5/6/81 - 11/4/81	3.6	3.7	6.5
Difference	3.5	6.9	10.4

Why is faster money growth necessary? The shift to monetary expansion is not accommodating a new burst of private loan demand. Total short-term business credit demands have tapered off in recent months. Moreover, inventories appear to be at or near a peak.

-- The Commerce Department's flash report for the 4th quarter indicates that substantial inventory liquidation is already underway -- real non-farm inventory investment is estimated to have dipped to $5.2 billion from $12.8 billion in 1981:3.

-- The latest report of the Purchasing Agents supports this estimate. It shows that in December 37.5% of the industries reported increases in inventories. This is down from 45.3% in November and 51.8% in October. Similarly, December also witnessed a rise in the percentage of industries reporting increases in new orders, from 32.8% in November to 37.8% in December.

Seasonally Adjusted Diffusion Indexes
(Derived from reports by the Purchasing Agents)

	Sept	Oct	Nov	Dec
New orders	45.0	41.3	32.8	37.8
Inventory	42.2	51.8	45.3	37.5

-- On the whole, private credit demand has eased during the past two months, although C&I loans continue at an unusually rapid rate for this stage of recession. This may reflect the shortage of liquidity among large and medium sized business firms, with long-term financing rates out of reach for many companies.

SMOOTHED GROWTH RATES*

	Short Term 1/ Business Credit	Total C&I Loans	NYC C&I Loans
Oct 7	32.0	18.2	15.5
Oct 21	27.1	20.4	18.1
Nov 4	18.8	15.5	13.1
Nov 18	18.6	11.5	6.8
Dec 2	20.6	13.9	10.0
Dec 16	17.6	17.9	9.2
Dec 23	15.3	19.0	6.0
Dec 30	12.9	20.4	7.0

1/ Short-term business credit consists of total C&I loans and nonfinancial commercial paper outstanding.

* For weekly data, smoothed growth consists of the average of 4-, 9-, and 13-week annualized rates of growth, not seasonally adjusted.

However, the Federal government continues as a heavy borrower. Unfortunately, Federal Reserve actions may be accommodating these demands in a mistaken effort to prevent upward interest rate pressures from developing during the recession. During the last quarter, the Treasury raised $37.5 billion in new money from marketable securities. This exceeded the Treasury's new cash borrowings in the 4th quarter of 1980 by 28% and was nearly double the new money raised by the Treasury in 1979:4.

Treasury New Cash Borrowing
($ in billions)

1979:4	18.6
1980:4	29.4
1981:4	37.5

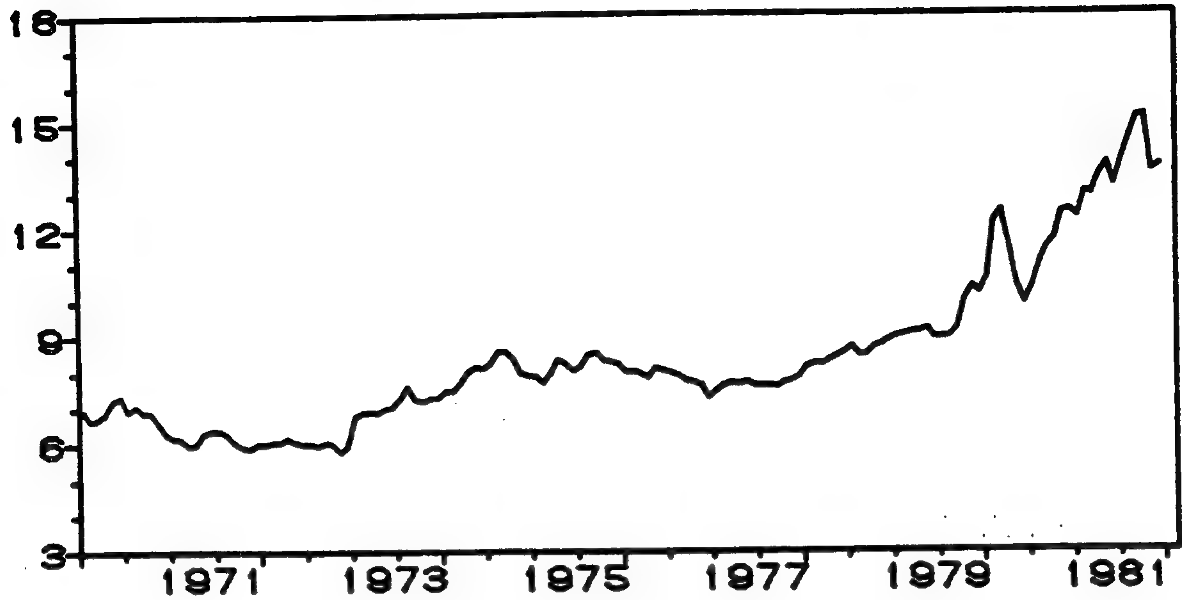
Higher interest rates, again. There are widespread doubts over the Administration's commitment to sustain a firm anti-inflation policy. Record deficits and debt expansion have become the concensus forecast. In this atmosphere the recent monetary explosion has only added fuel to the fire. As a result, interest rates have been driven sharply higher and a substantial share of the previous decline has been erased. Financial market attitudes have again turned pessimistic.

INTEREST RATES

	Treasury Securities			Corporate Securities	
	3-Month Bill	6-Month Bill	30-Year Bond	3-Month Paper	AAA Utility
Sep 28	14.1	14.6	15.1	15.5	17.7
Oct 19	13.5	13.8	14.7	14.7	17.1
Nov 9	11.2	11.6	13.6	12.6	16.2
Nov 23	10.5	11.0	13.4	11.2	15.2
Dec 4	9.9	10.3	12.9	11.2	14.7
Dec 7	10.2	10.7	13.3	11.1	15.2
Dec 14	10.9	11.6	13.3	12.5	15.9
Dec 21	11.1	11.8	13.5	12.5	15.7
Dec 28	11.3	12.3	13.2	12.7	16.2
Jan 6	11.6	12.4	14.3	12.4	16.2
Jan 13	12.1	12.9	14.5	12.7	16.9

If monetary expansion continues amidst widespread predictions of heavy Federal credit demands, interest rates will rise even more. This would mean that the cyclical troughs in interest rates may have been reached in early December 1981, with short-term commercial paper at 11% and long-term corporate bonds at 15%. Only a year or two ago these rate levels would have been record highs. Similarly, long-term Treasury bond rates hit December lows of 13%, much higher than the long rate bottoms of 7% in 1976 and 10% in 1980. This would represent the highest interest rate bottom in history.

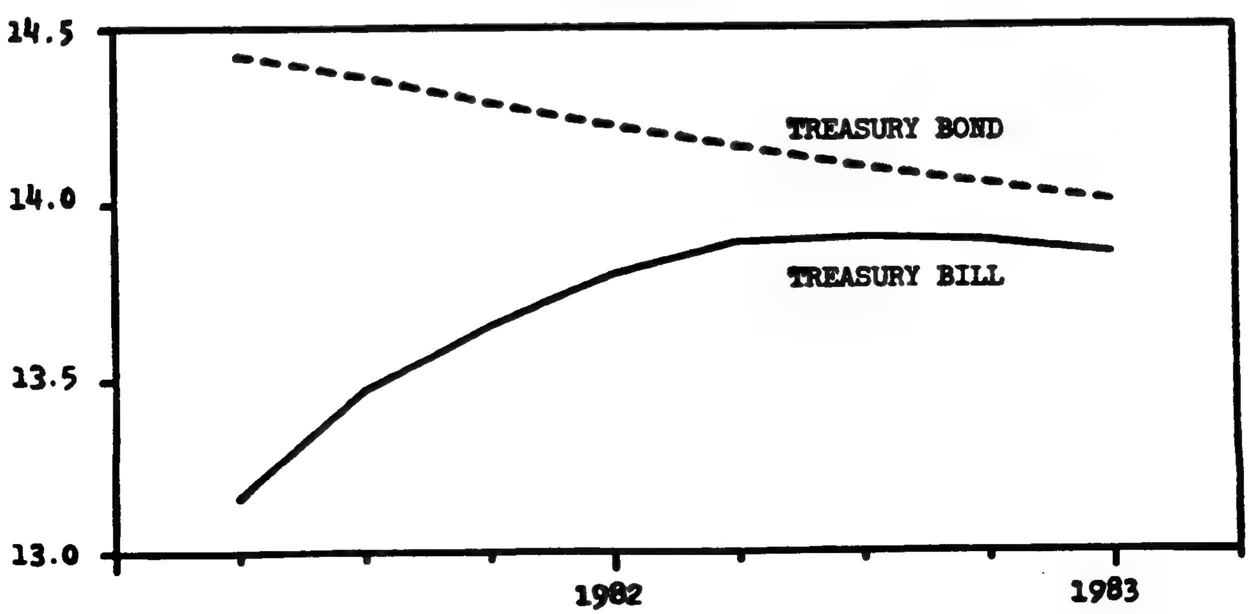
20-YEAR TREASURY BOND RATE



<u>Have Rates Actually Bottomed?</u> Yield curves in the Treasury futures markets indicate that long rates have nearly bottomed and short rates have in fact reached their cyclical troughs. In the short-term area, investors are anticipating a continuation of the steep run-up in the Treasury bill rate that began in early December. While the current 3-month bill rate is 12.1%, the March 1982 futures contract is trading at 13.2% and the December 1982 contract is 13.8%.

At the same time, the longer-term Treasury bond futures show only a very slight decline from its present level. The December 1983 bond futures contract is trading at 14.2%, which represents only a 30 basis point decline from the current rate on 30-year T-bonds in the cash market.

TREASURY FUTURES YIELD CURVES
(1/13/82)



Financial futures are suggesting that a prolonged series of record deficits, including the entire array of Federal credit programs, make a continuation of monetary restraint and declining inflation highly unlikely. This is not to say that the futures markets are always right; opinion is always capable of a quick reversal. Moreover, it is theoretically possible to sustain low money growth under almost any conditions. But the current market attitude suggests:

1) Projected heavy Federal credit demands for 1983-84 imply money growth and inflation in the 7-9% range.

2) With this large Federal presence in the credit markets, real interest rates are likely to be about 3-4%.

3) Long-term interest rates in the last two years appear to have embodied a 2-3% risk premium to allow for unprecedented market volatility and general uncertainty.

4) Assuming a continuation of these trends, interest rates on long-term government securities are unlikely to fall below 13% in the near-future and could very easily be higher.

5) Business firms and financial institutions have had little or no time to reliquify their balances sheets. As a result, they will have to pay substantial risk premiums for long-term financing. Therefore, yields on corporate bonds may exceed those on long-term governments by a wide margin.

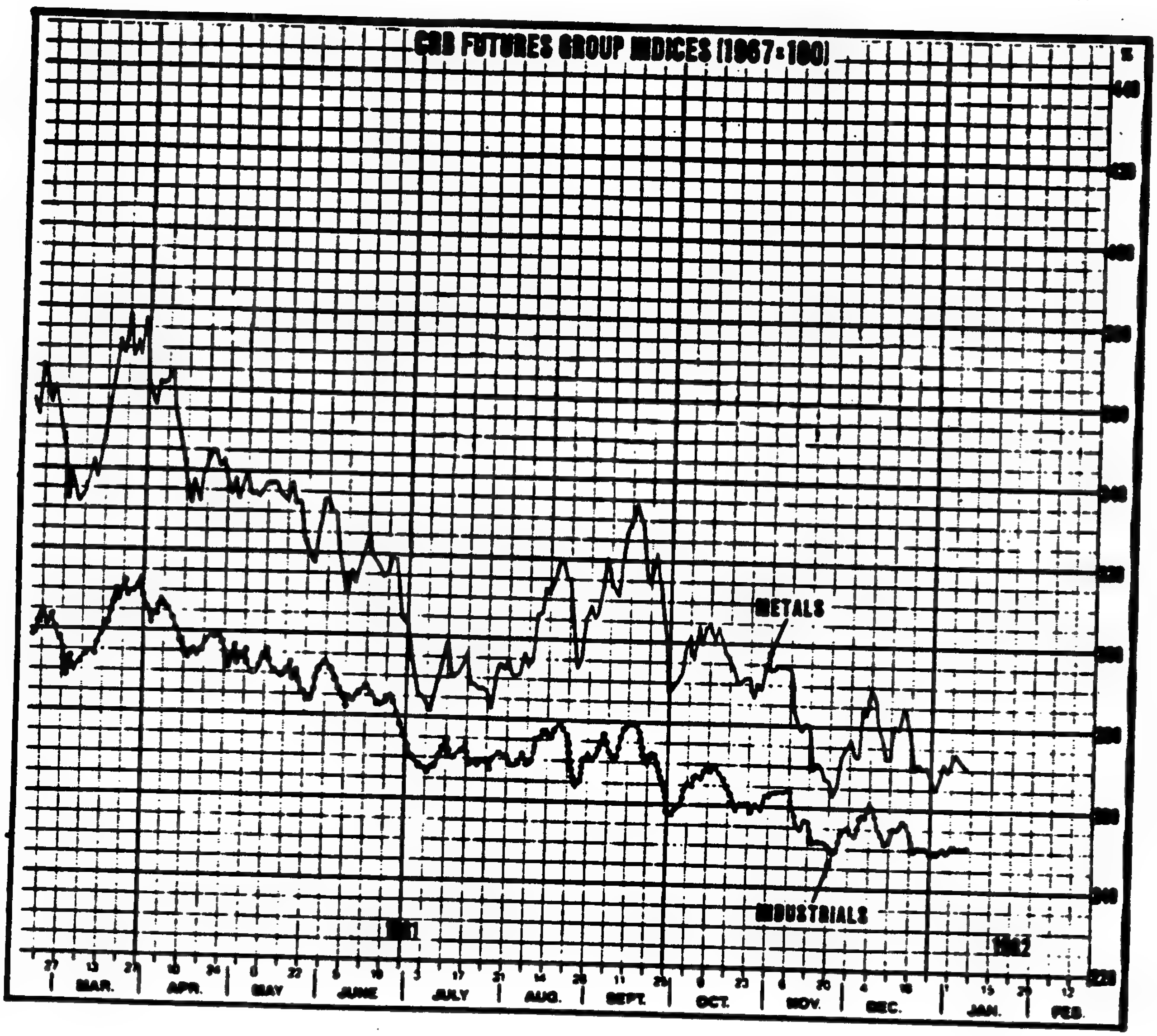
Concern about a possible reacceleration of inflation is not restricted to the interest rate markets. A similar apprehension has been developing in the commodities area. Excesses in fiscal and monetary policy cheapen the value of money and raise the anticipated value of commodities and other real assets. Thus, price movements in commodity futures provide a useful barometer of inflation expectations.

Currently the Commodity Research Bureau's (CRB) index of future prices stands at about 258, which represents a drop of nearly 25% from its high of 337 in November 1980. But practically all of this decline occurred during the first half of 1981, as the index fell to about 267 by the end of June. Since then, this broad-based index of commodity futures prices has essentially bottomed, with some strengthening in recent weeks.

__Commodity Research Bureau's__
__Index of Futures Prices__

1980	Nov 21	337.3 (Historical peak)
1981	June 26	266.5 (Mid-year low)
	July 2	267.4
	Dec 11	255.2
	Dec 18	253.4 (Bottom)
	Dec 24	254.2
	Dec 31	254.9
	Jan 8	258.2

Also on the futures front, prices of metals and other industrial commodities are more sensitive to movements in the economy than is the CRB's broad-based index. As illustrated below, these prices fell until late November, but have since shown some tendency to rise. This is one of numerous signs that an economic upturn may not be far off.



But the inflation situation has improved substantially. Over the most recent 12-month periods, the CPI increased by 9.5% and the PPI increased by 7.0%. These rates represent significant declines from 1978-80 trends.

Annual Inflation Rates

	CPI	PPI	GNP Deflator
1977	6.5	6.5	5.8
1978	7.7	7.8	7.3
1979	11.2	11.1	8.5
1980	13.5	13.5	9.0
Average	9.7	9.7	7.6

(One disconcerting note in this generally favorable performance is the recent uptick in the 3-month rate of change of the PPI. After dropping to 2.8% in September this measure of inflation rose to 5.4% in December.)

	CPI % Change from		PPI % Change from	
	3 months Earlier	12 months Earlier	3 months Earlier	12 months Earlier
January	11.8	11.7	9.2	11.4
February	11.2	11.3	9.5	10.7
March	9.6	10.5	13.3	10.9
April	8.2	10.0	11.7	10.9
May	7.0	9.8	9.9	10.8
June	7.4	9.5	6.8	10.5
July	10.8	10.7	5.2	9.0
August	11.5	10.8	4.1	7.9
September	13.5	10.9	2.8	7.8
October	9.8	10.1	3.4	7.3
November	8.4	9.5	5.1	7.1
December	NA	NA	5.4	7.0

A major reason for this disinflation is the gradual decline in longer term monetary growth trends which began in 1979. Following this trend, the general inflation rate is likely to decline somewhat more in 1982. Other contributing factors to the favorable inflation outlook in 1982 include moderate wage demands and the cyclical rise in productivity.

-- On the union side of the labor markets, collective bargaining in 1982 will be very heavy, involving 3.6 million workers or nearly 40% of total workers covered by major agreements. The largest new contracts to be negotiated involve industries, such as autos and construction, which have been quite depressed for some time. Under these circumstances some concessions from labor would seem highly likely, and this could affect the wage prospects for other union and nonunion workers alike. In fact GM and the UAW have just agreed to negotiate some cuts in wages or benefits to be passed on to consumers in the form of lower auto prices.

The Calendar of Major Collective Bargaining Activity for 1982

Month	Industry	Workers Covered (in thousands)
January	Oil refining	88
March	Trucking	544
April	Construction & Rubber	312
May	Construction & Apparel	530
June	Elect. Equip., Food Process. and Construction	499
July	Elect. Equipment	166
August	Food production	138
September	Autos	1023
	Other	250
TOTAL		3600

-- Once the recovery begins there should be a fairly robust growth in productivity. Growth of output per hour averaged 4.4 percent during the initial four quarters of the past six cyclical recoveries.

-- 1982 could thus experience a 1 to 2 percentage point decline in the rate of unit labor costs, which suggests some further decline in inflation this year. After 1982, though, the prevailing market view is that inflation will reaccelerate.

Has the Recession Bottomed? Most indices of stock market performance seem to be suggesting that the current recession may nearly be over. They do not, however, point to a strong recovery.

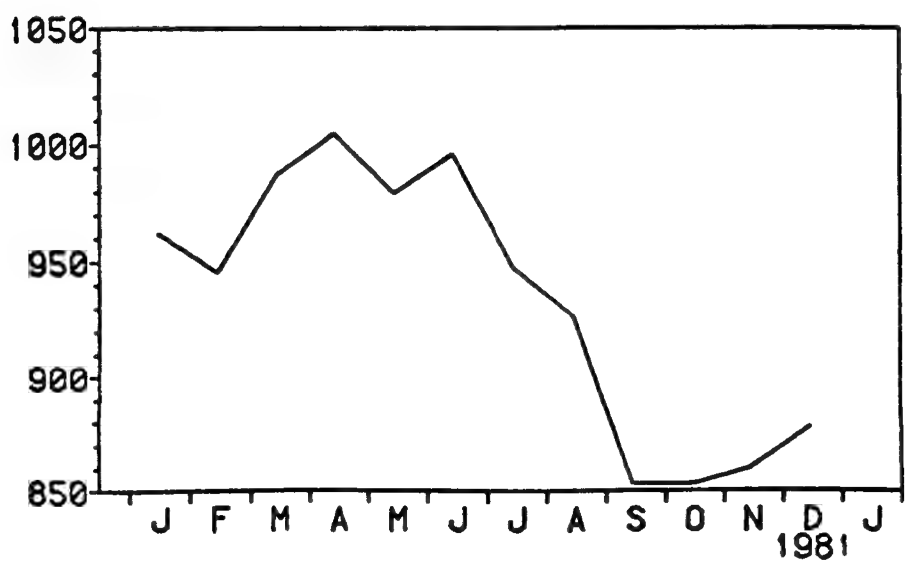
-- The stock market is considered a good leading indicator. Through the years, it has predicted economic trends 3-6 months in advance.

-- The two broad-based indices of stock prices (the S&P 500 and the Dow Jones Industrials) both topped out in April 1980, three months before the peak in the economy.

-- Even with the pronounced weakness in stock prices in recent days, the Dow Jones averages are still about 20 points higher than the low of 829 reached in the week ending September 25, 1981.

1981	S&P 500	Dow Jones
January	133.0	962
February	128.4	945
March	133.2	987
April	134.4	1005
May	131.7	980
June	132.3	996
July	129.1	948
August	129.6	926
September	118.3	853
October	119.8	853
November	122.9	860
December	123.8	878

DOW JONES IND. INDEX



The stock price behavior of key industries also shows a bottoming recession.

S&P Price Indexes (1941-43 = 10)

	June	Aug	Sept	Oct	Nov	Dec	Prelim Trough	% ch since trough
Home furnishings	29	28	25	28	30	29	Sept	14.6
Mobile homes	77	71	62	70	75	72	Sept	15.7
Railroads	91	91	79	84	90	91	Sept	15.2
Paper containers	226	214	193	195	204	218	Sept	12.6
Consumer goods	109	100	94	97	98	98	Sept	4.2
Food	83	79	76	79	81	82	Sept	8.6
Automobiles	63	54	51	46	42	43	Nov	1.7
Capital goods	145	141	127	124	126	128	Oct	3.4
Business equip.	1077	1012	952	920	921	949	Oct	3.2

-- The price indices of construction-related stocks -- home furnishings and mobile homes -- have risen about 15% above their September lows of 25 and 62, respectively. This indicates that construction activity may have already begun its recovery.

-- Railroads and paper containers are considered good barometers of general business conditions. The price index of railroad stocks has risen 15.2% from a low of 79 in September. Investors seem to be saying that the upturn in the economy is about to begin. This does not support the views of analysts who forecast a prolonged recession.

-- The composite index of capital goods stocks seemed to have touched bottom at 124 in October and risen only 3 1/2 percent during the subsequent two months. Market participants appear to be acting on the correct assumption that capital goods usually lag other sectors in the recovery process.

-- One area which shows continuing weakness is the auto industry.

Other indicators tell the same story. They also suggest that the worst of the slide in economic activity may have already occurred and that the trough of the current recession does not seem far off.

- o The bottom of the housing cycle may have already been reached, and seeds of a recovery are beginning to bud.

  -- Starts of single-family homes (which are quite sensitive to the availability and cost of mortgage credit) registered a low of 508,000 units in October. In November they increased 27% to 645,000 units.

  -- After declining 40% during the first 9 months of 1981, single family home sales ticked up 14% in October and a further 11% in November.

  -- There was a 1 percentage point decline in FHA-VA mortgage rate in November from October's high of 18.5%. Other mortgage interest rates are starting to fall. Conventional mortgage rates are estimated to have declined 3/4 percentage point to 17% in December. In recent weeks mortgage rates have edged up slightly, in line with the general upturn in market rates.

  -- The All-Savers and 2 1/2-year certificates were responsible for the first rise ($76 billion) in deposits at thrift institutions since last May. Deposits at thrift institutions also increased in November, but at a much slower rate ($28 billion).

S&L and MSB Saving Flows
($ billions, annual rate)

	Total	All-Savers Certificate	6-month MMC	2 1/2 Year Certificate	Jumbos	Traditional (other) Deposits
May	22.4	NA	79.2	-10.8	10.8	-56.8
June	-26.2	NA	32.4	22.4	4.8	-86.2
July	-41.2	NA	55.2	1.2	3.6	-101.2
August	-3.7	NA	-6.0	96.0	10.8	-104.5
September	-5.4	NA	-54.0	139.2	12.2	-102.6
October	75.8	237.6	-178.8	133.2	13.2	-129.4
November	28.1	39.6	72.0	76.8	10.8	-27.1

o New car sales may have also touched bottom in October, but there is still no evidence of any real recovery. The auto weakness is partly a pricing problem. New car prices have advanced 27% since the fourth quarter of 1979 while auto sales have decline about 30% during this period.

New Auto Sales Millions Units
(SAAR)

	Total	Domestic	Import
May	7.9	5.7	2.2
June	7.5	5.3	2.2
July	8.2	5.9	2.3
August	10.4	8.2	2.2
September	8.8	6.7	2.1
October	7.2	5.2	2.1
November	7.6	5.4	2.3
December	7.3	5.0	2.3

o New orders for nondefense capital goods may have also hit bottom in October, reaching $21.1 billion.

-- Nondefense goods rose 10% in November, perhaps indicating the start of a new upward trend.

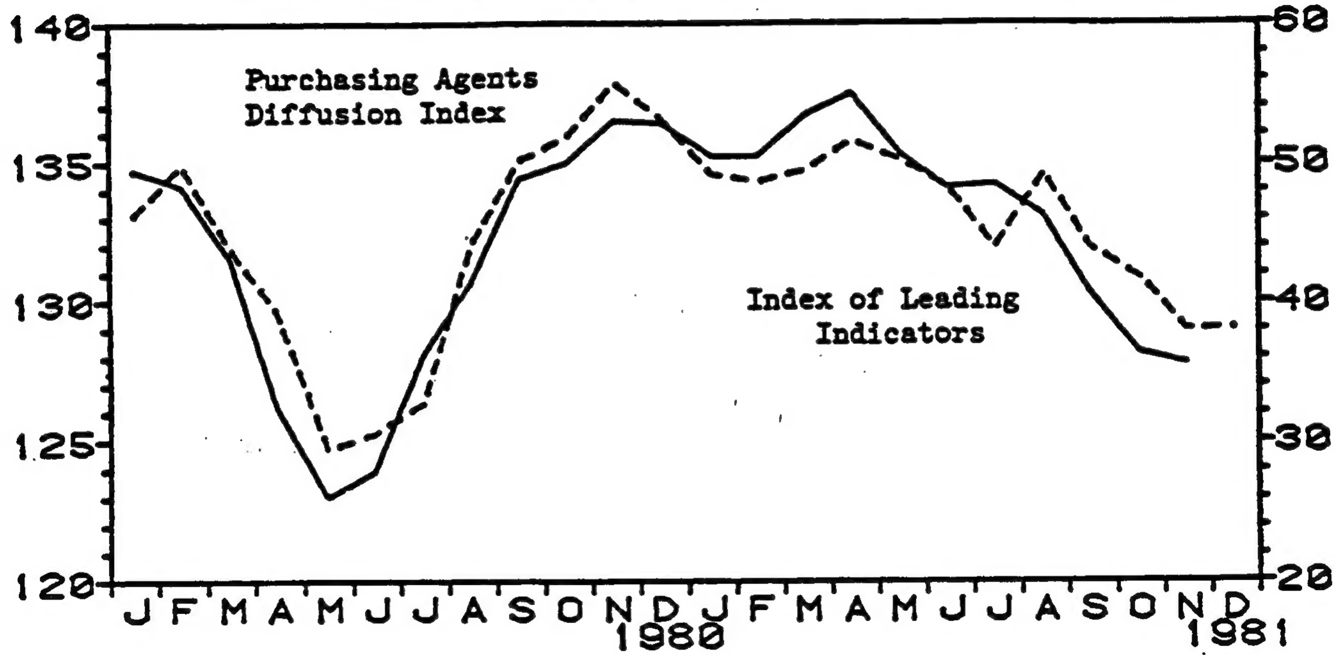
-- The latest report of the Purchasing Agents suggests that a further gain occurred in December.

o The index of leading economic indicators declined only 0.3% in November.

-- This followed larger declines of 1.6% and 2.1% in October and September, respectively.

-- Based on the behavior of the Purchasing Agents' overall diffusion index, December's index of leading indicators is likely to be flat.

LEADING INDICATORS COMPOSITE INDEX VS PURCHASING AGENTS DIFFUSION INDEX



o The ratio of coincident to lagging indicators (C/L ratio) is another measure that portends future business conditions. As shown below, this ratio ticked up in October and November after five consecutive months of decline.

1981	C/L Ratio	% change from previous months
March	78.7	2.7
April	79.4	0.9
May	75.1	-5.4
June	74.6	-0.7
July	74.0	-0.8
August	73.7	-0.4
September	73.0	-0.9
October	74.0	1.4
November	75.6	2.2

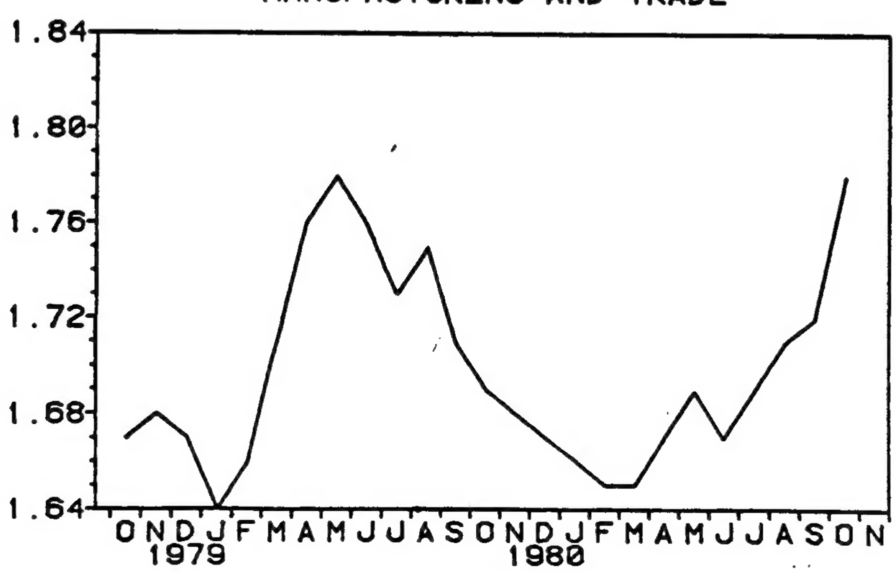
o Initial unemployment claims declined from a high of 597,000 in early December to 506,000 during the week ended January 2.

Week Ending	Initial Unemployment Claims (in thousands)
November 28	533.4
December 5	597.0
December 12	558.4
December 19	552.4
December 26	515.3
January 2	506.0

o The inventory-to-sales (I/S) ratio for the total manufacturing and trade sectors has been rising since last summer, as shown below:

1981	Nominal I/S	Real I/S
June	1.39	1.67
July	1.40	1.69
August	1.42	1.71
September	1.44	1.72
October	1.48	1.78
November	1.50	NA

CONSTANT DOLLAR INVENTORIES TO SALES RATIO
MANUFACTURING AND TRADE



- The real inventory-to-sales ratio provides a better indicator of cyclical activity. The ratio generally rises through recession periods, hitting its cyclical peaks when the economy approaches its trough.

  -- In the current recession, the I/S ratio climbed to 1.78 by October, the last month for which data are available. This is a matter of concern; it indicates that there are still imbalances in the economy.

Looking up from the bottom: Is sustainable recovery possible?

If the current monetary acceleration represents a major shift in policy, the economic recovery will come sooner rather than later. The scheduled reductions in the tax burden will also contribute to an earlier recovery. As a best guess, real growth in 1982:1 is likely to be flat, but this could represent a turning zone for the economy and lead to much stronger growth in the second quarter. However, a combination of rising interest rates and a belated monetary correction could create a 1982 second half which is much more sluggish. The recovery could become a non-event.

At current interest rate levels the economy's financial situation is as fragile as ever. Business and financial firms have not been able to reliquify their balance sheets as yet, and private credit demands are likely to be unusually strong at this stage of the business cycle. Excessive Federal and federally-assisted borrowing will compete with these private credit demands, and this competition for capital is likely to absorb valuable investment resources and generate additional interest rate pressures as the year continues.

The heavy credit demand/high interest rate/sluggish recovery scenario may not actually take place, but right now this seems to be the best guess of investors in the interest rate, commodity and stock markets. To reverse investor pessimism, credible new fiscal policy initiatives to reduce Federal spending and borrowing will be necessary. Moreover, to insure steady improvement in market expectations about future inflation, new fiscal initiatives must be accompanied by a reliable program of monetary restraint. But right now, market attitudes are not encouraging.